PUBLIC SERVICE COMMISSION OF WISCONSIN

Memorandum

November 20, 2006

TO: The Commission

FROM: Robert Norcross, Administrator
Jacquelin Madsen, Case Coordinator
Gas and Energy Division

RE: Application of Superior Water, Light and Power Company for Authority to Increase Retail Electric, Gas and Water Rates — 5820-UR-110

BRIEFING MEMORANDUM

This is a Class 1 contested case to consider the application of Superior Water, Light and Power Company (SWLP or applicant) for authority to increase its retail electric, gas, and water rates in 2007. The application was filed pursuant to Wis. Stat. §§ 196.03, 196.20, and 196.37.

On May 1, 2006, SWLP filed an application for authority to change its electric, natural gas, and water rates effective January 1, 2007. SWLP requested a $1,379,374 (4.6 percent) increase for electric operations, a $667,654 (2.4 percent) increase for its natural gas operations, and an increase of $1,283,034 (19.8 percent) for its water utility operations. The water utility increase is based on the proposed construction of an elevated water tower. Additionally, due to the proposed water tower project, SWLP requested a subsequent year rate adjustment for its water utility of $141,960 (1.8 percent).

Based on its audit, Commission staff estimates an $812,000 (2.83 percent) increase for electric operations, a $384,000 (1.41 percent) increase for natural gas operations and a $566,000 (8.83 percent) increase to water operations. The requested water utility increase is substantially decreased due to the removal of the elevated water storage project from the filed application.

The elimination of the project also negates the need for the requested second year rate adjustment. The revenue deficiencies are based on an 11.0 percent rate of return on common equity.

The purpose of this proceeding is to address the revenue requirement, cost-of-service, and rate design needed to authorize final rates for the 2007 test year.

On August 8, 2006, a prehearing conference was held by the Commission. SWLP and Commission staff prefiled direct, rebuttal and surrebuttal testimony.

On November 6, 2006, a video conference hearing was held in Madison and Superior. No briefs were filed.

This briefing memorandum provides background and discussion of positions on contested issues, based on the record in this proceeding. This memorandum also presents alternatives for each contested issue.

Revenue Requirement

1. Should 2007 gross receipts tax expense be increased to reflect the applicant's updated estimate of 2006 electric revenues?

Background

SWLP filed supplemental testimony requesting an update to the forecasted 2007 Gross Receipts Tax (GRT) expense. SWLP indicates that due to the dramatic upward trend of the Fuel Clause Adjustment (FCA) component of its purchased power agreements and the increased sales of its largest electric customer the 2006 revenues and the resulting 2007 GRT expense will be much higher than projected in its filing. The revenue impact for the revised GRT expense is estimated by the applicant to be $93,135. (Holt, Tr. 43; Ex 27) SWLP seeks only to revise the 2007 GRT expense.

The estimated increase to 2006 electric revenues and 2007 GRT expense was not reflected by Commission staff because SWLP brought this issue to staff's attention well after audit completion. (Madsen, Tr. 109-110)

Discussion

Commission staff completed its audit in August 2006. Since audit completion, SWLP has reviewed its estimates and filed a request to revise 2006 electric sales and the resulting 2007 GRT. The request is based on actual revenue information available through September 2006.

Gross receipts tax expense is determined by applying the GRT rate to revenues received in the previous year. The applicant determined the 2007 GRT expense using 2006 budgeted data adjusted for known changes at the time of the initial rate filing. (Holt, Tr. 41) SWLP argued that the upward trend of the FCA component of its purchased power agreement with Minnesota Power could not be foreseen and the resulting increase to 2006 revenue would result in a higher than anticipated 2007 GRT expense. (Holt, Tr. 41-42)

SWLP cites a second contributing factor for the requested 2007 GRT expense level increase. SWLP's single largest electric customer provided the company with 2007 test year kWh levels that are 26.5 percent higher than the actual 2005 levels. While the company included these increased levels of sales in its 2007 test year sales and revenue calculations, they were not included with the known and measurable changes made to the 2006 budget data used to determine the 2007 GRT expense level. As a result the GRT expense calculated for the 2007 test year is understated and the under-recovery of GRT expense caused by the increasing FCA is exacerbated. (Holt, Tr. 41-43)

While the upward trend of the FCA component of its purchased power agreement with Minnesota Power could not be anticipated, nor could the understated levels of the 2006 budgeted information be known, at the conclusion of the audit the filed 2006 electric revenue and 2007 gross receipts tax expense estimates appeared reasonable to all parties. Without the opportunity to review the updated information, staff cannot verify if the requested 2007 GRT expense increase is reasonable. (Madsen, Tr. 109-110)

The Commission has a long standing practice regarding the need to audit late-filed information. The Commission order in docket 6630-UR-102, dated December 28, 1988, states:

> Unless there are particularly compelling and unusual circumstances, the auditing staff applies a general policy of not changing its revenue requirement.
>
> This general policy has three exceptions for which changes are made:
>
> 1. Errors in mathematics will be corrected.
> 2. The effects of new law, actually adopted, will be incorporated.
> 3. Estimates which are recognized as contingent on later events at the time when made may be corrected if the event which creates the contingency occurs and resolves or reduces the uncertainty.
>
> The Commission realizes that the closer the test year, the more refined a projected income statement becomes. An audited income statement is considered to reflect a reasonable level of operations for the test year. Increase requests received after the audit cut-off point may refine the income statement but are generally assumed to be offsetting against other refinements and therefore, as a rule, staff does not incorporate these changes.
>
> At times circumstances do warrant further review of individual items, but the utility should not be able to choose among these changes and have its choice incorporated into the staff's revenue requirement, for the obvious reasons that the utility has a stake in the outcome and regulatory oversight would be undermined if it were allowed.

Alternative One: Approve applicants filed estimate of 2007 gross receipts tax expense.

Alternative Two: Approve applicants revised forecast of 2006 electric revenue and 2007 gross receipts tax expense.

2. Should the Commission staff's audit adjustments made to SWLP's filed revenue requirement be included in the final revenue requirement? (Uncontested)

3. Electric and Gas Demand-Side Management

- **a. What are the appropriate electric and natural gas conservation escrow budget levels to be included in the revenue requirement? (Uncontested)**

- **b. Are SWLP's customer service conservation activities appropriate? (Uncontested)**

FINANCIAL

4. What is a reasonable capital structure for ratemaking in this docket?

Background

SWLP's filing included 60.06 percent common equity. (Erickson, Tr. 16) Commission staff's proposed test year capital structure included 57.38 percent common equity. (Hubert, Tr. 81)

Discussion

SWLP proposed increasing the ratio of common equity in its capital structure. During its audit, Commission staff removed proposed equity infusions and reinstated normal dividends resulting in a capital structure containing 53.80 percent equity. Subsequently, Commission staff developed a capital structure containing 57.38 percent common equity.

SWLP's proposed capital structure exceeds historic levels. (Hubert, 82, Ex. 28 Sch. 8) However, SWLP argues that it has already made the equity infusion and its September 30, 2006, common equity ratio is 61.10 percent. Furthermore, the company intents to manage its capital structure to maintain the proposed common equity ratios. The higher equity ratio is necessary to balance its business risk. (Erickson, Tr. 29) Alternative One reflects the amount of equity in SWLP's filed test year capital structure.

The higher equity comes at a cost to ratepayers. (Hubert, Tr. 82) Consequently, a reasonable common equity ratio will provide adequate equity; neither too little nor too much. Exhibit 29 Sch. 2 provides Standard & Poor's debt and equity guidelines. Alternative Two reflects the fact that the Commission is not bound to the specific proposals of the parties. The upper bound reflects SWLP's filing and the lower bound reflects Commission staff's initial test year capitalization.

Alternative One: A reasonable level of common equity for the test year average is 60.06 percent.

Alternative Two: A reasonable level of common equity for the test year average is _____ percent. (A number between 53.80 percent and 60.06 percent)

5. What is a reasonable interest rate for SWLP's variable rate industrial revenue bonds? (Uncontested)

6. What is a reasonable embedded cost for SWLP's long-term debt? (Uncontested)

7. What is a reasonable interest rate for SWLP's short-term borrowing? (Uncontested/Decision Required)

8. What is a reasonable return on equity for the test year?

Background

SWLP's filing is based on a return on equity of 11.7 percent. (Erickson, Tr. 17; Ex. 9, Sch. 1) Commission staff testified that, based on economic data available in June 2006, a range of 10.00 percent to 11.30 percent would be reasonable and Commission staff used a point estimate of 11.00 percent. (Hubert, Tr. 92) Delayed Exhibit 38, to be filed approximately one week prior to the Commission's decision, will provide current economic and financial information. (Hubert, Tr. 94)

Discussion

Commission staff performed discounted cash flow analyses on a large portfolio of energy utility stocks and a large portfolio of low-risk non-utility stocks. In addition, Commission staff performed an interest rate premium calculation. (Hubert, Tr. 85-86; Ex. 28, 38) Commission staff estimated a return on equity range of 10.00 percent to 11.30 percent and used a point estimate of 11.00 percent based on several factors, including: capital costs have remained relatively low at levels not seen for 40 years; Commission staff has used 10.9 percent in Wisconsin Power and Light Company's and Wisconsin Public Service Corporation's 2007 test year rate dockets; and Commission staff had proposed 11.0 percent in North Central Power Company's rate case. (Hubert, Tr. 91-92) In regards to the latter, the September 13, 2006, Final Decision in docket 4190-ER-104 granted North Central Power Company an authorized return on equity of 11.70 percent. (Hubert, Tr. 91)

SWLP argues that the 11.0 percent is too low. It testified that SWLP has historically earned returns substantially less that those authorized and its credit worthiness is predicated on its ability to earn its authorized return. In addition, because of the disallowance of $374,000 associated with its Results Sharing and Incentive Compensation programs, the company will in effect earn 0.9 percent less that any return authorized. Furthermore, SWLP's business risk is greater than that of the comparable companies identified by Commission staff. Lastly, SWLP argued that the average before-tax interest coverage in most recent orders for other companies averaged 5.71 while its test year before-tax interest coverage was only 4.74. (Erickson, Tr. 24-28) Commission staff testified that a distinction needs to be made between financial and regulatory capital structures. Large off-balance sheet obligations included in the financial capital structure translate into higher equity in the regulatory capital structure. Exhibit 29, Schedule 1 provides before-tax interest coverage information on both the regulatory and financial basis. It is the financial capital structure on which credit quality is evaluated. (Hubert, Tr. 95-96)

Alternative One is based on Delayed Exhibit 38, which will provide current economic and financial information. Alternative Two is based on SWLP's request. In its filing, SWLP used an 11.7 percent return on equity. (Ex. 9, Sch. 1) Alternative Three is based on Commission staff's analysis in June 2006.

Alternative One: Based on current economic conditions, a reasonable rate of return on SWLP's common equity is a percentage based on Delayed Exhibit 38.

Alternative Two: A reasonable rate of return on SWLP's common equity is the company's proposed 11.7 percent.

Alternative Three: A reasonable range for the rate of return on SWLP's common equity is between 10.00 percent and 11.30 percent.

9. What are reasonable inflation rates for years 2006 and 2007? (Uncontested/Decision Required)

ELECTRIC REVENUE ALLOCATION, RATE DESIGN AND COST-OF-SERVICE STUDIES

10. What is the appropriate electric revenue requirement allocation? (Uncontested)

11. What is the appropriate electric rate design? (Uncontested)

12. Should SWLP be required to work with Commission staff to determine the type of information to be gathered to examine rate restructuring and time-of use rate options for its customers in its next rate case? (Uncontested)

Discussion

There are no SWLP time-of-use options available to residential customers. Only secondary customers with demands over 1,000 kW and primary customers with demands over

500 kW are billed on a time-of-day basis. (Ex. 31, Sch. 2) All secondary customers with demand over 10 kW and under 1,000 kW are on the same tariff and all primary customers with demand under 500 kW are on the same tariff. Insufficient customer information is available to allow rate restructuring and the development of time-of-use rate options in this docket. SWLP agreed to work with Commission staff to determine the types of billing and load information that could be used to determine whether or not rate restructuring is necessary and the development of time-of-use rate options. (Erickson, Tr. 30)

Uncontested Alternative: Determine that SWLP work with Commission staff to determine the type of information to be gathered to examine rate restructuring and time-of use rate options for its customers in its next rate case.

NATURAL GAS REVENUE ALLOCATION, RATE DESIGN AND COST-OF-SERVICE STUDIES

13. What range of natural gas cost-of-service studies (COSS) should be utilized to establish class revenue allocation and rate design? (Uncontested)

14. What is the appropriate natural gas rate design?

Revenue Allocation Proposals Including Natural Gas Costs							
			Commercial Use			Interruptible Use	
Allocation	Overall Increase	Residential Use	Small		Large	Small	Large
Commission Staff (CS)	1.41%	1.13%	1.04%		1.29%	1.40%	1.51%
SWLP	2.38%	2.18%	2.43%		2.68%	2.69%	3.0%

Discussion

SWLP proposed raising distribution margins consistent with its COSS, but retaining one gas acquisition charge for all classes. Commission staff proposed implementing separate gas acquisition charges for each class, and made minor changes to the distribution margins.

Alternative One: Commission staff's rate design proposal as shown in Exhibit 35 is most appropriate.

Alternative Two: SWLP's rate design proposal as shown in Exhibit 11 is most appropriate.

WATER REVENUE ALLOCATION, RATE DESIGN AND COST-OF-SERVICE STUDIES

15. Is the water cost of service study (COSS) submitted in this case reasonable? (Uncontested)

16. What is the appropriate water rate design? (Uncontested)

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